No. 10906

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

BARNHART-MORROW CONSOLIDATED,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

OPENING BRIEF OF PETITIONER.

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Introduction.

This is a proceeding for review of a decision of the Board of Tax Appeals (47 B. T. A. 590) and of an order of The Tax Court of the United States refusing to vacate said decision and grant a rehearing. The parenthetical references set forth in this brief are to the pages of the printed transcript of record.

Statement of Basis of Jurisdiction.

The jurisdiction of the Board of Tax Appeals (the name of which was changed by Section 504(a) of the Revenue Act of 1942 to "The Tax Court of the United States") is based upon Sections 1101 and 272(a) of the Internal Revenue Code. The jurisdictional facts are alleged in the petition [R. 5-6] and are admitted in the answer [R. 53].

The jurisdiction of this Honorable Court is based upon Sections 1141(a) and 1142 of the Internal Revenue Code. The decision of the Tax Court was entered on January 24, 1944, and the order denying petitioner's motion to vacate the decision and for a rehearing was filed February 29, 1944 [R. 4]. The taxpayer's petition for review was filed May 15, 1944 [R. 5].

The venue is determined by Section 1141(b)(1) of the Internal Revenue Code and the allegation in the petition for review [R. 301] that the taxpayer's returns were filed with the Collector of Internal Revenue for the Sixth District of California.

Statement of the Case.

Petitioner is a California corporation engaged in the production of oil and gas. In 1927 it acquired by assignment the right to operate certain oil wells in the Santa Fe Springs Field known as wells Nos. 1, 2, 3, 11 and 12 [R. 186-7]. Well No. 12 was abandoned the same year [R. 68]. On September 28, 1928, petitioner acquired a leasehold interest in certain land on which it drilled a productive well known as well No. 16 [R. 187-8]. And in 1930, petitioner entered into an agreement pursuant to which it placed on production a well on adjacent premises known as well No. 17 [R. 189].

In January, 1931, while petitioner was operating the said wells Nos. 1, 2, 3, 11, 16 and 17, an action was instituted in the Superior Court of the State of California entitled *Julian v. Schwartz*. Petitioner was made a party to said action by cross-complaints in which the defendant and certain other persons claimed to be the owners of the said six wells and of all production therefrom [R. 190]. On March 19, 1931, the court in said action appointed two

individuals as receivers to operate the wells and impound the net proceeds of production, and on March 23, 1932, the court appointed two trustees to take over the duties of these receivers. The litigation was finally terminated, favorably to petitioner, on October 28, 1936 [R. 190-191].

On July 29, 1931, an action was filed in the Superior Court of the State of California by one D. R. Morrow, seeking, among other things, an accounting of the affairs of petitioner, and on the same day the said court appointed Ralph S. Armour as receiver for petitioner [R. 191-2]. This appointment did not disturb the possession of the wells by the receivers and trustees appointed in the case of *Julian v. Schwartz* [R. 194].

During the calendar year 1935 petitioner sustained a loss of $6,063.64 [R. 193], and Exhibit 51 [R. 104], a schedule of balance sheets according to petitioner's books [R. 83], shows that at the end of that year petitioner had a deficit of $172,161.65. The financial condition of petitioner remained about the same until November, 1936, when petitioner received from the trustees the impounded proceeds of production [R. 195-6].

It was agreed by representatives of the Treasury Department and of the trustees in charge of the wells that no income tax liability should be imposed upon the trustees, but that funds distributed by the trustees should be taxed to the recipients for the years in which the distributions were made [R. 80-81]. However, gas revenues produced by wells Nos. 1, 2, 3 and 11 were released by the trustees in 1933 and subsequent years and were treated as constructively received in those years by petitioner. In determining petitioner's net income for those years, receivership expenses were allowed as deductions for the

years in which they were approved by the court which appointed the receiver [R. 84-5, 196].

On November 12, 1936, the receiver, Ralph S. Armour, filed an account showing additional receivership expenses of $17,852.12. The court approved the account the same day and directed payment of such expenses out of the first moneys accruing to petitioner [R. 197-8]. On November 14, 1936, the trustees delivered possession of the wells to petitioner, and during said month the trustees paid $112,000.00 to petitioner and the said sum of $17,852.13 to said Ralph S. Armour [R. 198].

It was determined in the case of *Julian v. Schwartz* that petitioner and one J. A. Smith were each entitled to a one-half interest in well No. 16 [R. 190-191]. Petitioner had been operating this well at a loss when, in 1937, it ceased producing entirely. The cost of making necessary repairs could not be determined in advance [R. 199]. Although the well had some salvage value, probably $2,000, it would have cost petitioner between $5,000 and $10,000 to plug the well as required by the laws of the state. Accordingly, petitioner, in December, 1937, quitclaimed its interest in the well to said J. A. Smith [R. 199-200], and claimed as a loss the book value of the interest so surrendered.

Specification of Errors Relied Upon.

(1) The Tax Court erred in holding and deciding that petitioner was not insolvent, within the meaning of Section 14(d)(2) of the Revenue Act of 1936, at any time during the year 1936.

(2) The court erred in holding and deciding that the evidence was insufficient to show petitioner's right under

Sections 14(a)(2) and 26(c)(3) of the Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942, to deduct its deficit in accumulated earnings and profits as of December 31, 1935, in determining undistributed net income for the year 1936.

(3) The court erred in failing to make findings of fact with respect to petitioner's asserted right to the deduction referred to in paragraph (2) above.

(4) The court erred in denying petitioner a rehearing for the purpose of proving its right to the deduction referred to in paragraph (2) above.

(5) The court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1936, to deduct $11,908.53 of the $17,852.12 paid in 1936 as receivership expenses.

(6) The court erred in holding and deciding that petitioner was not entitled, in determining its net income and undistributed net income for the year 1937, to deduct the loss sustained upon relinquishment of its one-half interest in well No. 16.

(7) The court erred in redetermining a deficiency of $14,509.17 in petitioner's income tax and undistributed profits surtax for the calendar year 1936.

(8) The court erred in upholding respondent's determination of a deficiency of $15,816.89 in petitioner's income tax and undistributed profits surtax for the calendar year 1937.

ARGUMENT.

I.

During the Year 1936 Petitioner Was Insolvent Within the Meaning of Section 14(d)(2) of the Revenue Act of 1936.

Section 14(d) of the Revenue Act of 1936 provides in part as follows:

> "(d) Exemption From Surtax.—The following corporations shall not be subject to the surtax imposed by this section:
>
> * * * * * * * *
>
> "(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia."

It is undisputed that during the first ten months of 1936 petitioner was in receivership. And there is no question as to the test of insolvency under Section 14(d)(2), it having been settled by the decision of this Honorable Court in *Artesian Water Co. v. Commissioner*, 125 F. (2d) 17, that the taxpayer is insolvent if unable "to meet its obligations as they matured, in the usual course of trade or business." The issue before the Tax Court, and now on review, is whether or not petitioner, early in 1936, was insolvent by this test.

It should be observed at this point that insolvency at any time during 1936 is sufficient to entitle petitioner to

the exemption claimed. As stated in *United States v. Anderson Co.* (C. C. A. 7), 119 F. (2d) 343, 345:

> ". . . no tax is due if the taxpaying corporation in receivership 'is insolvent for one day of said taxable year.'"

Let us examine the evidence as to the financial condition of petitioner on January 1, 1936. In the year 1931 petitioner had sustained a net loss of $90,116.67, and the years 1932-1935, inclusive, had brought additional losses of over $13,000.00 [R. 193]. Petitioner's balance sheet as of December 31, 1935, showed a deficit of $172,161.65 [R. 195]. For almost five years all of the capital assets shown on the balance sheet (with the exception of office furniture carried at $811.50) had been in the possession of receivers and trustees appointed in the case of *Julian v. Schwartz,* and, as the court found [R. 195], "were being claimed by Schwartz and the holders of participating oil agreements as asserted in the proceeding." Had Schwartz and the holders of participating oil agreements prevailed in the litigation, petitioner would have been hopelessly bankrupt, for not only were they claiming the oil wells as their own, but they were also asserting an obligation on the part of petitioner to account for past production [R. 98-99].

The admitted liabilities of petitioner on December 31, 1935, disclosed by its balance sheet, amounted to $43,789.66. These liabilities had not been materially reduced in the past five years [R. 104]. They consisted of notes payable in the amount of $3,000.00 (unchanged during 1935), accounts payable in the amount of $17,267.70 (substantially the same as during the preceding two years), $1,396.68 accrued interest, $1,051.66 accrued taxes, ac-

crued payroll of $14,078.00 (unchanged for two years), and $6,995.63 due to stockholders.

The Tax Court, in its opinion [R. 206], says that the record does not disclose whether any of these debts (except accrued salary of $14,000.00) "matured during the receivership." The fact that they were matured obligations, however, is evident from the classifications of the balance sheet, Exhibit 51 [R. 104]. These classifications, "Notes *payable*," "Accounts *payable*," "*Accrued* expenses," and "Due to Stockholders," are a sufficient *prima facie* showing that the liabilities listed were neither contingent nor unmatured. There is no evidence to the contrary, and the sufficiency of the showing made by petitioner was never questioned by counsel for the Commissioner.

The true basis, however, of the Tax Court's decision that petitioner was not insolvent on January 1, 1936, is its misunderstanding of one item in Exhibit 51. Listed in the balance sheet as of December 31, 1935, under the heading "Other Assets," is "Capital stock issued for services and leases" in the amount of $219,120.50. The Tax Court said [R. 206]:

> "* * * No attempt was made to show inability to meet maturing debts by a reasonable use of credit. It is true that the oil and gas properties were in the possession and control of the trustees and for that reason could not have been used by the receiver as collateral for a loan, but he had under his control stock of a book value of about $220,000. Nothing of record is opposed to the idea that this stock could have

been used as security for a loan or sold to pay debts. Neither does it appear that an application was ever made to the court for permission to sell receiver's certificates or otherwise raise funds to meet matured obligations."

When this opinion was promulgated petitioner at once moved for a reconsideration, pointing out [R. 229-230] that the capital stock referred to by the court was not an investment in stocks of other corporations, but was a mere bookkeeping debit item, representing that portion of the Capital Stock item of $694,977.00, listed as a liability, which represented shares of petitioner issued to promoters for services and leases. In other words, the $219,120.50 represented stock of *petitioner* issued to *others*.

As stated in Paton's *Accountants' Handbook,* Third Edition, pages 36, 40, 128 and 844, in the application of accounting principles to financial statements a logical arrangement of the assets and liabilities may follow either of two sequences: (1) in order of liquidity, or (2) in the inverse order of liquidity. Intangibles are usually listed as the last or next to the last item on the asset side and should invariably be listed separately. Some of the principal intangible items are (1) purchased good will, (2) patents, franchises, copyrights, etc., (3) long term prepayments or deferred charges, and (4) organization costs. In organizing a corporate enterprise substantial expenditures are often required to cover services of promotion and incorporation and the activities involved in raising capital.

The balance sheet [R. 103] followed the accepted principle of arranging and presenting the assets in order of liquidity, the intangibles separately and next to the last group of accounts. The intangible asset of "Capital stock

issued for services and leases" was listed with other intangible assets of the company. As the words themselves imply, the stock was *issued* by the company and not received by it through purchase as an investment. Furthermore, if the item had been an investment in stocks of other companies, then, in accordance with accepted principles of accounting, the item would have *preceded* the caption "Capital Assets" on the balance sheet.

In other words, "Capital stock issued for services and leases" is a phrase intended to describe the transaction through which intangible promotional benefits were received by petitioner. These benefits, of course, have no realizable value.

We believe the Tax Court should have paused to reflect that if petitioner had possessed a marketable asset worth anything like $219,120.50, the court which appointed the receiver would long before have ordered a sale of this asset to pay liabilities. The receiver's final account showed that even receivership expenses had remained unpaid for many years [R. 197.] Finally, the Tax Court should have realized that counsel for the Commissioner would have pointed out an asset worth $219,120.50 if it actually existed.

This glaring error was called to the attention of the Tax Court by motion for reconsideration. Attached to the motion was the affidavit of George F. Meitner, petitioner's auditor, stating:

> "that the item on Petitioner's Balance Sheet, Exhibit No. 51, 'Capital Stock Issued for Services and Leases $219,120.50,' referred to stock issued by Petitioner to others for services and leases, and was simply an intangible item of no value, being what is commonly called 'promotion stock.' "

Certain other errors were corrected by supplemental orders [R. 244-5, 270-72]; yet the statement was allowed to remain in the opinion that petitioner possessed capital stock of a book value of almost $220,000, and the motion for reconsideration was denied.

Exhibit 51 was not the only evidence of petitioner's insolvency at the beginning of 1936. *The testimony of petitioner's attorney stands undisputed that until the funds impounded by the trustees appointed in the case of Julian v. Schwartz were released, petitioner was without funds to pay its obligations or conduct its affairs* [R. 119-120].

Let us see, now, whether petitioner could under the circumstances have raised such funds by borrowing on its assets or by the issuance of receiver's certificates, as suggested by the court. Its accounts receivable, listed at $35,507.19, are described in the balance sheet, Exhibit 51, by the phrase "collection and realization on which will exceed one year." Of the total, $7,104.61 due from C. C. Julian remained constant for five years, and the court found [R. 191] that he died in 1934, leaving no estate. The next item, $21,978.09 due from "W. J. Barnhart and/or East Santa Fe Springs Escrow Account," remained constant during the years 1933, 1934 and 1935 and was definitely not an asset upon which anything could be realized. Nothing had been collected on Sundry Accounts of $296.31 since 1931. The amount receivable from the Texas Co. represented, as stated in the exhibit, gas revenues withheld. It would, of course, depend upon the outcome of the litigation in *Julian v. Schwartz* whether

petitioner or others were entitled to these revenues. Finally, the item of $4,518.22 shown as due from J. A. Smith is explained by the statement "Contra against indebtedness due him" and was thus not collectible.

The California superior court's order of November 12, 1936, terminating the receivership, recited the fact that petitioner was "no longer insolvent, by reason of its success in the litigation entitled Julian v. Schwartz" [R. 198]. The Tax Court said that this statement was not helpful because insolvency was not the ground for the receivership, and that "inability to pay due to impounding of assets in a receivership, not based upon grounds of insolvency, is not proof of insolvency in the sense of inability to meet maturing debts." This statement was directly contrary to the decision of this Court in *Artesian Water Co. v. Commissioner, supra,* where we find the following:

> "The Commissioner in his brief divides his argument upon this phase of the case into two subdivisions. First it is urged that 'the receivership intended by this section was obviously intended to mean one caused by financial difficulties and not one arising from disputes between the stockholders, charges of mismanagement, failure to obey the laws, etc.' We do not agree. There is nothing in the statute or in the authorities to our knowledge that provides that in order to fall within the terms of the statute a corporation must be in receivership because of its insolvent condition. So far as the statute provides, it is enough if the corporation is insolvent and in re-

ceivership, and the nature of the receivership proceeding is immaterial.

*   *   *   *   *   *   *   *

"It is certain, of course, that the taxpayer was not insolvent in a bankruptcy sense of having liabilities exceeding assets. As stated above, its assets exceeded one million dollars, and its liabilities were less than one hundred and fifty thousand dollars. We are unable to agree with the apparent holding of the Board that a corporation must be insolvent within this sense of the word in order to be entitled to exemption. See United States v. Anderson Co., 7 Cir., 119 F. 2d 343, 346, and authorities therein cited.

"It follows, then, that if the finding of solvency is to be affirmed, it must be on the basis that the taxpayer was able to meet its obligations as they matured, in the usual course of trade or business. We find no support in the record for such a finding. It is clear that the notes to the Pacific Mutual Life Insurance Company became due after the 'informal extension,' in the year 1937, the tax year in question. It is equally clear that the taxpayer was unable to meet this obligation at its maturity, either from its current assets or with 'the reasonable use of the debtor's credit.' United States v. Anderson Co., *supra*. As stated above, all of the taxpayer's income bearing assets were pledged to the Insurance Company as security for the loans, and in view of the receivership taxpayer's hands were just as effectively tied as if it had been in bankruptcy. As well put by the taxpayer in its brief, 'The solvency or insolvency

> of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petitioner is found in the taxable year, and not in some false and assumed situation in which it is not found, for example, free from receivership.' "

In the present case petitioner was unable to pay its matured debts, not because of the receivership, but because of other litigation in which the title to substantially all its assets and the income derived therefrom was claimed by other persons. The trustees appointed in the case of *Julian v. Schwartz* were mere stakeholders, without power except to operate the wells and impound the net proceeds of production until the rightful owners should be determined by the court. During the pendency of the litigation it is clear that these assets were not available for the payment of petitioner's debts.

It therefore appears that during the early part of 1936 petitioner had matured liabilities which had remained constant for several years and that it was entirely without funds and without access to assets from which funds could be realized. It is submitted that during the period in question petitioner was clearly unable to meet its matured obligations and was therefore insolvent within the meaning of Section 14(d)(2).

If, however, there was any deficiency in proof of insolvency, petitioner should have been given an opportunity to supply the necessary additional evidence. The authorities which support petitioner's right to this further opportunity are set forth at a later point in this brief.

II.

Petitioner Was Entitled, in Computing Its Undistributed Net Income for 1936, to Deduct Its Deficit as of December 31, 1935.

The opinion of the Tax Court in this case was promulgated on August 20, 1942. Section 501(a) of the Revenue Act of 1942, which became law on October 21, 1942, retroactively amended Section 14(a)(2) of the Revenue Act of 1936 to read as follows:

> "The term 'undistributed net income' means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26(c) relating to restrictions on payment of dividends, (C) except in cases where section 26(c)(1) is applicable, the deficit credit provided in section 26(f), and (D) the redemption credit provided in section 26(g)."

and retroactively added to the Revenue Act of 1936 Section 26(c)(3), reading as follows:

> "In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936."

These amendments were made applicable to the instant case by Section 346 of the Civil Code of the State of California, as amended in 1933, reading as follows:

> "A corporation may declare dividends payable in cash or in property only as follows:
>
> "(1) Out of earned surplus; or

"(2) Despite the fact that the net assets of the corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period which shall not be less than six months nor more than one year in duration; or

"(3) Out of paid-in surplus or surplus arising from reduction of stated capital subject to the provisions of section 348b, Civil Code, only upon shares entitled to preferential dividends; provided that notice shall be given to the shareholders receiving such dividends of the source thereof prior to or concurrently with the payment thereof.

"*Impaired assets.* If the value of the net assets amounts to less, through depreciation, depletion, losses, or otherwise, than the aggregate amount of stated capital attributed to shares having liquidation preferences, the corporation shall not declare dividends out of net profits pursuant to subdivision (2) of this section, except upon such shares, until the value of the net assets has been restored to such aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences.

"*Dividends.* No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation's debts and liabilities would exceed its assets or that it would be unable to meet its debts and liabilities as they mature.

"No dividends shall be declared out of the mere appreciation in the value of its assets not yet realized, nor shall any dividends be declared from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.

> "*Wasting asset corporation.* A wasting asset corporation, that is a corporation engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents or other wasting assets, or organized solely or substantially to liquidate specific assets, may distribute the net income derived from the exploitation of such wasting assets or the net proceeds derived from such liquidation without making any deduction or allowance for the depletion of such assets incidental to the lapse of time, consumption, liquidation or exploitation; subject, however, to adequate provision for meeting debts and liabilities and the liquidation preferences of outstanding shares and to notice to shareholders that no deduction or allowance has been made for such depletion."

That Section 346 of the California Civil Code is such a law as is contemplated by Section 501(a) of the Revenue Act of 1942 was recognized by the Tax Court in *Signal Oil Company v. Commissioner,* 2 T. C. 90, 96 (Commissioner's acquiescence noted C. B. 1943, p. 20).

Petitioner had no right to declare dividends in 1936 under sub-paragraph (2) of Section 346, for during its preceding accounting period it sustained a net loss of $6,063.64 [R. 193]. It was therefore prohibited by Section 346 from declaring dividends until such time as it might have a capital surplus. Petitioner's balance sheet as of December 31, 1935, showed a deficit of $172,161.65, and it claims the right, under the retroactive amendment, to deduct this sum in computing its undistributed net income for 1936. The effect, of course, would be to eliminate entirely any surtax on undistributed profits for that year.

The 1942 amendments to the Revenue Act of 1936 became effective after the submission to the Tax Court in this case of petitioner's motion for reconsideration or rehearing, but were called to the attention of the court in petitioner's computation for entry of decision, filed March 26, 1943 [R. 252-4], and at the hearing under Rule 50 on May 5, 1943. At this hearing, as stated in the Tax Court's order of February 29, 1944 [R. 297-8], petitioner submitted its contention that it was entitled to a deficit credit upon the facts already in the record, but only because the court advised counsel for petitioner that new evidence could not be considered at a hearing under Rule 50. Mr. Meitner, appearing for petitioner, was of the opinion that the deficit shown on Exhibit 51 might have to be recomputed by substituting cost depletion for percentage depletion, in the same manner as required for determining the source of distributions under Section 115 (see Reg. 111, Sec. 29.115-6). He stated, however, that he did not believe this recomputation would affect the amount of the deficit shown on Exhibit 51 [R. 262]. The court then said [R. 262-3]:

> "We don't like to try these cases upon recomputation. . . . Now, it is obvious that there is a real reason for not bringing in new facts, new proof, new evidence, upon a recomputation. I don't think that that should be considered upon this recomputation at all; that I should hear you on new evidence. But I am not saying that perhaps you might be allowed to file a motion for reconsideration, to set up such new facts if you show proper grounds for doing so."

Mr. Meitner then called attention to the deficit of $172,-161.65 as of December 31, 1935, shown on Exhibit 51, Part 2, and explained [R. 264]:

> "I am not proposing any new evidence unless the court deems it proper, if new evidence is necessary to sustain that figure. In other words, not now."

It is clear that counsel was merely abiding by the court's ruling that new evidence could not be considered at a hearing under Rule 50 and was not waiving the right to offer such evidence at a later time if it should appear to be necessary.

Then followed the Tax Court's order of July 30, 1943 [R. 270-272], which corrected the figures as to gross income, operating expenses, and net income, and ordered the parties to submit recomputations under Rule 50, but which made no mention of petitioner's claim to a deficit credit. Revised recomputations were then filed, and the application of Section 501 was again presented by petitioner [R. 298]. On January 24, 1944, the court entered its decision [R. 285], in which, again, no mention was made of the new issue. Petitioner then filed its motion to vacate the decision and for a rehearing, stating that upon the rehearing it would submit, in support of its claim to the deficit credit, an analysis of the deficit account as of December 31, 1935 [R. 287]. This motion was disposed of by the order of February 29, 1944, in which the court said [R. 299-300]:

> "The present motion raises no question not already examined and considered over a long period, and so far as suggestion of new evidence is concerned, comes after petitioner's decision on May 5, 1943, to stand upon the original evidence. The only additional evidence now suggested by motion is an analysis of the

deficit account. Nothing newly discovered, since the hearing on the issue on May 5, 1943, is suggested. The record evidence has, upon the earlier presentations of the question, been found insufficient to show right to the deficit corporation credit. In the light of the entire record here, and after repeated presentation and consideration of this question, no just reason is found to vacate the decision of January 24, 1944, and the petitioner's motion is therefore denied."

Now, it is apparent from the record that this decision was most unjust to the petitioner. The evidence is said to be insufficient to show petitioner's right to the deficit credit, but the court does not explain wherein the evidence is deficient. The court says that the suggestion of new evidence "comes after petitioner's decision on May 5, 1943, to stand upon the original evidence," whereas the record shows, as demonstrated above, that petitioner made no such decision on May 5, 1943, but on the contrary was prevented by the court from offering additional evidence, since the hearing was merely to settle differences in computation under Rule 50. The court then says that the additional evidence suggested is not shown to be newly discovered since the hearing on May 5, 1943. This might be a ground for denying a rehearing if petitioner had had an opportunity on May 5, 1943, to present evidence, but we have shown that petitioner had no such opportunity.

The decision of the court that petitioner was not entitled to a deficit credit in determining its 1936 undistributed net income is not supported by any presumption in favor of the Commissioner's findings, for the right to the deficit credit was created by the Revenue Act of 1942, long after the Commissioner's determination of a deficiency. The presumption of correctness which ordi-

narily attaches to the Commissioner's findings does not apply to issues raised for the first time after the notice of deficiency.

> *First Nat. Bank of Boston v. Commissioner of Int. Rev.* (C. C. A. 1), 63 F. 2d 685, 693-4.

Furthermore, the presumption in favor of the Commissioner's determination is merely a procedural device and is not in itself evidence to be weighed against evidence produced by the taxpayer. In *J. M. Perry & Co. v. Commissioner,* 120 F. (2d) 123, 124, this Court said:

> "It follows that the Commissioner must have found that the corporation was 'availed of' for that purpose. This finding is presumptively correct, that is, until the taxpayer proceeds with competent and relevant evidence to support his position, the determination of the Commissioner stands. When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof. Welch v. Helvering, 290 U. S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212; Helvering v. National Grocery Co., 304 U. S. 282, 294, 295, 58 S. Ct. 932, 82 L. Ed. 1346; Helvering v. Talbott's Estate, 4 Cir., 1940, 116 F. 2d 160, 162."

Where evidence is produced by the taxpayer alone, it is the duty of the Tax Court to make findings on the basis of such evidence, without regard for any presumption in

favor of the Commissioner's determination. Thus, in *Hemphill Schools v. Commissioner,* 137 F. (2d) 961, 963-4, this Honorable Court remanded the case to the Tax Court, saying:

> "The Board's holding that petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting gains and profits to accumulate instead of being divided or distributed appears to have been based on respondent's determination that petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. Whether that determination was correct or incorrect was the principal, if not the sole, issue in the case. The burden of proving it incorrect rested on petitioner. Thus, if no evidence had been produced, the Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct.
>
> "Evidence *was* produced. Some of the evidence produced by petitioner tended to prove that its gains and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence.' It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

See also *Lawrence v. Commissioner,* decided by this Court on June 13, 1944, in which the Court said:

> "The Tax Court also stated in its opinion that petitioners had failed to overcome the presumption that respondent's determination of their tax liability was correct. That presumption disappears when, as here, evidence is introduced which would be sufficient to sustain a contrary finding (Wiget v. Becker, 84 F. 2d 706, 707-8; Co-operative Publishing Co. v. C. I. R. (9 Cir.), 115 F. 2d 1017, 1021-2; *cf.* New York Life Ins. Co. v. Gamer, 303 U. S. 161, 171)."

Here the only evidence before the Tax Court was Petitioner's Exhibit 51, Part 2 [R. 104], showing a deficit of $172,161.65 as of December 31, 1935, and the stipulation of counsel that Exhibit 51 was a schedule showing balance sheets as per petitioner's books [R. 83]. This was certainly evidence tending to prove a deficit in accumulated earnings and profits in the stated amount. Of course, circumstances can be imagined which might affect the weight to be given the balance sheet as evidence of accumulated operating losses (although *Byron Sash & Door Co. v. United States* (D. C., Ky.), decided April 10, 1944, holds that no adjustment of the balance sheet deficit is required even for prior capitalization of earned surplus); but no evidence of any such circumstance was presented to the Tax Court. It is submitted that the balance sheet was *prima facie* evidence which, standing uncontroverted, required a finding in favor of petitioner.

The Tax Court did not even attempt to make a finding as to whether or not petitioner had "a deficit in accumulated earnings and profits as of the close of the preceding taxable year." This, in itself, would require that the case be remanded, for it is not a function of the Circuit Courts

of Appeals to make findings of fact. In *Bell v. Commissioner* (C. C. A. 3), 139 Fed (2d) 147, it appeared that the taxpayer claimed as a basis for determining gain or loss on the sale of corporate stock the cost of bonds which he had exchanged for the stock in what he claimed was a tax-free reorganization under Section 112(g)(1) of the Revenue Act of 1936. After the Tax Court, on January 19, 1943, had filed its memorandum decision in favor of the Commissioner, the taxpayer presented a motion for reconsideration on the ground that the exchange was a tax-free transfer to a controlled corporation, within the meaning of Section 112(b)(5) as construed by the Supreme Court in *Helvering v. Cement Investors, Inc.*, a case decided June 1, 1942. The Circuit Court of Appeals said (pages 148-9):

> "It is also true that neither party brought that provision of the Revenue Act or the Supreme Court's construction thereof in the Cement Investors case to the attention of the Tax Court prior to its decision. However, the petitioner did move timely for a reconsideration of the Tax Court's decision and specified as the reason for his motion the pertinency of Sec. 112(b)(5). In that way the point now advanced by the petitioner was raised below; and the Tax Court terminated the matter by entering an order denying the petitioner's motion for a reconsideration of the decision.
>
> * * * * * * * *
>
> "In the Cement Investors case it was undisputed (see 316 U. S. at page 531, 62 S. Ct. at page 1127, 86 L. Ed. 1649) that 'the stock and income bonds acquired by each bondholder were substantially in proportion to his interest in the assets of the debtor companies prior to the exchange.' In the instant case

> there has been no finding in such regard. In view of the statute's cognate requirement, the necessity for an appropriate finding in material connection is readily apparent. Each party has presented argument in support of his respective contention as to what the relevant finding should be on the basis of the record facts. But it is no part of our province, upon the review of a decision by the Tax Court, to make fact findings. That duty devolves upon the authorized fact finder. We have naught to do therefore but to remand the case to the Tax Court for a finding with respect to the material fact indicated and for decision thereafter in the light of the findings as they then exist."

It is submitted that, in the light of the evidence that petitioner had a deficit as of December 31, 1935, the Tax Court erred in deciding, without even making a finding as to the existence or non-existence of a deficit in accumulated earnings as of the close of the preceding year, that there was a deficiency in surtax on undistributed profits for the year 1936. But, erroneous as was this decision, much more arbitrary and erroneous was the refusal of the court on February 29, 1944, to allow petitioner a rehearing for the purpose of presenting additional evidence in support of its claim to a deficit credit. The Tax Court should have been willing, in the interests of justice, to determine whether or not petitioner was entitled to the benefit of the retroactive amendments made by Section 501(a) of the 1942 Act. Instead, the court sought plausible excuses for denying petitioner the opportunity to present the facts. Under such circumstances an appeal to a higher court of justice should never be unavailing.

Nor have such appeals been unavailing in the past. In *Chatham Phenix Nat. Bank & Trust Co. v. Helvering*

(C. C. A., D. C.), 87 F. (2d) 547, 549-50, the Circuit Court of Appeals for the District of Columbia said:

> "We realize that the burden was upon the taxpayer to prove its case, and that it failed to introduce sufficient evidence in this respect, but we are here confronted with a case wherein it is perfectly clear that, by reason of the unauthorized action of Brady in attempting to appear as a representative of the taxpayer (for which, as we gather from the record, the Board punished him by disbarment from further practicing before it), there was really no hearing according to law, and in which it appears that there may be a valid claim on the part of the taxpayer for a refund of the tax paid. We think, under these circumstances, that a hard and fast rule should not be applied, the result of which may be to enrich the government unjustly and punish the taxpayer.
>
> "The taxpayer appeals from both the division member's order of December 21, 1934, denying a retrial, and the decision of the Board refusing to review the order of December 21, 1934. As to the order of December 21, 1934, neither the applicable statutes nor the rules of practice adopted by the Board of Tax Appeals deal specifically with motions for rehearing. It has been held, however, that the Board has power to grant a rehearing, Helvering v. Continental Oil Co., 63 App. D. C. 5, 8, 68 F. (2d) 750; Burnet v. Lexington Ice & Coal Co. (C. C. A.), 62 F. (2d) 906, 908; Garden City Feeder Co. v. Commissioner of Internal Revenue, 27 B. T. A. 1132, and, further, that the granting of a rehearing lies within the sound discretion of the Board, Bankers' Pocahontas Coal Co. v. Burnet, 287 U. S. 308, 313, 53 S. Ct. 150, 151, 77 L. Ed. 325. Undoubtedly the court has jurisdiction to determine whether, under all the circumstances, that discretion has been abused.

"But the power of this court to order a rehearing of the case does not extend only to the abuse of discretion on the part of the Board. This power may be exercised when necessary to meet the ends of substantial justice. This court has the power under the statute to modify or reverse the decision of the Board, if not in accordance with law, 'as justice may require.' 44 Stat. 110, section 641 (c), T. 26 U. S. C., 26 U. S. C. A. Sec. 641 (c). The cases disclose numerous instances where this broad power has been exercised. Dempster Mill Mfg. Co. v. Burnet, 60 App. D. C. 23, 46 F. (2d) 604; L. J. Christopher Co. v. Commissioner of Internal Revenue, 60 App. D. C. 368, 370, 55 F. (2d) 530; Underwood v. Commissioner of Internal Revenue (C. C. A.), 56 F. (2d) 67, 73; Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue (C. C. A.), 56 F. (2d) 1028 1033; Helvering v. Edison Securities Corp. (C. C. A.), 78 F. (2d) 85, 91, 92; Fritz v. Commissioner of Internal Revenue (C. C. A.), 76 F. (2d) 460, 461; Commissioner of Internal Revenue v. Langwell Real Estate Corp. (C. C. A.), 47 F. (2d) 841, 842; Slayton v. Commissioner of Internal Revenue (C C. A.), 76 F. (2d) 497, 498.

'In the Virginia-Lincoln Case, *supra,* the court said: 'In addition to this, it appears from the record that petitioner is entitled to relief; and we will not turn him out of court because he may have misconceived his remedy. As we have said before, courts exist to do justice, not to furnish a forum for the technical skill of counsel. In reviewing a decision of the Board, we are given broad powers to affirm, modify, or reverse it "as justice may require" (26 U. S. C. A., Sec. 1226); and we do not think that justice requires that a petitioner with a meritorious

case be turned out of court upon any such technical ground.'

"In the Fritz Case, *supra,* in considering a petition to review a decision of the Board, the Circuit Court of Appeals for the Fifth Circuit said: 'We should not upset this finding of fact unless the board abused its discretion in refusing to reopen the case for further evidence. We recognize on the one hand that the board has discretion as a *quasi* court touching the reopening of its proceedings. Bankers' Pocohontas Coal Co. v. Burnet, 287 U. S. 308, 309, 53 S. Ct. 150, 77 L. Ed. 325; Weiller v. Commissioner (C. C. A.), 64 F. (2d) 480; Wise & Cooper Co. v. Commissioner (C. C. A.), 53 F. (2d) 843; Washburn Wire Co. v. Commissioner (C. C. A.), 67 F. (2d) 658, 659. And on the other hand our power and responsibility on review extend to the requirement of further trial when error of law, surprise, or arbitrary action makes it proper.'

"Running through all the cases cited is the similar determination of the courts that, where it appears that a further hearing would be promotive of justice, the taxpayer should be given the opportunity of amending his pleadings and of offering evidence to show that he suffers through a wrongful determination of his tax liability."

The same court, in *Ohio Valley Rock Asphalt Co. v. Helvering,* 95 F. (2d) 87, 90, said:

"When to all of this is superadded the fact that after the Board's decision and in apt time petitioner asked leave to produce additional evidence to cover its default in evidence on the point mainly relied on by the Board, and was refused, it seems to us clear that the Board's decision to reject the entire claim is wholly unsustainable. Petitioner, as we think, has

shown that the Commissioner's determination of its tax liability is excessive and that to sustain it would impose upon petitioner the duty of paying a tax that confessedly it does not owe. In similar circumstances the Supreme Court has said that the Board should hold the assessment arbitrary and invalid and should afford the taxpayer an opportunity to show whether a fair apportionment may be made and, if so, the correct amount of the tax. Helvering v. Taylor, 293 U. S. 507, 55 S. Ct. 287, 79 L. Ed. 623.

"As we have indicated above, we think there is sufficient evidence in the record on which the Board could have made a reasonable estimate of some, if not all, of the factors upon which depletion is computed. And if it be said that the estimates would be only rough approximations it may be replied, as the Supreme Court said in United States v. Ludey, 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054, that it is better to act upon a rough estimate than to ignore the fact of depletion. In view of petitioner's application for a rehearing and for an opportunity to produce evidence which was not available to it at the former hearing, simple justice requires that petitioner be granted further opportunity to present its proof. We, therefore, remand the cases to the Board with instructions to consider the testimony already taken and such further competent testimony as may be offered, to find the facts, and to determine the correct amount of the assessment on that basis."

We respectfully represent to this Honorable Court that every fact necessary to show petitioner's right to a deficit credit under Section 501(a) of the Revenue Act of 1942 can be established by competent evidence, and we submit that, in the interests of justice, this case should be remanded to the Tax Court with instructions to permit such evidence to be presented.

III.

Petitioner Was Entitled to Deduct Receivership Expenses Paid in 1936 in Determining Its Net Income and Undistributed Net Income for That Year.

The Tax Court found [R. 197-8] that on November 12, 1936, Ralph S. Armour filed with the Superior Court of the State of California his account as receiver showing expenses incurred in the total amount of $17,852.12, and that on the same day the said court approved the account and directed payment of the said sum out of the first moneys accruing to petitioner. The findings also show that the impounded funds paid by the trustees in 1936 included $17,852.13 paid to Armour for the account of petitioner [R. 198].

The Commissioner, in his notice of deficiency, had disallowed the deduction of $11,908.53 of this amount on the ground that expenses in that amount "properly accrued prior to the taxable year" [R. 46]. This disallowance was alleged in the taxpayer's petition to be error [R. 7], and the Commissioner's answer put this allegation in issue [R. 53]. Thereafter, counsel for the parties entered into a stipulation in which it was agreed [R. 83-5] that in determining petitioner's net income or loss for the years 1933, 1934 and 1935, the Treasury Department had allowed deduction of receivership expenses "in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061, wherein the said Ralph S. Armour was receiver" [R. 85].

The Tax Court in its findings [R. 196] stated petitioner's income and expenses for the year 1936 *and included among expenses receivership expenses in the sum of*

$17,574.68, the amount shown on Petitioner's Exhibit 60. The record does not explain the discrepancy between this figure and the $17,852.13 found to have been paid the receiver by the trustees.

Notwithstanding this finding as to petitioner's income and expenses for 1936, the Commissioner, in submitting his computation under Rule 50, deducted only $5,666.15 as receivership expenses for the year 1936. This was called to the attention of the Tax Court in the computation filed by petitioner on March 26, 1943 [R. 250], and again in its recomputation filed on or about January 1, 1944 [R. 275], but the decision was nevertheless based upon the Commissioner's computation as to receivership expenses deductible. Petitioner thereupon filed its motion to vacate the decision, asserting that in disallowing the additional deduction of $11,908.53 as receivership expenses, the decision was contrary to the stipulations of counsel and the court's own findings. The motion, as heretofore stated, was denied by order of February 29, 1944, in which the court made only the following mention of the matter of receivership expenses [R. 296-7]:

> "All of the matters presented by the present motion had, prior to the filing thereof, been throughly considered. On December 4, 1942, motion filed September 17, 1942, for rehearing, including consideration of the issues now raised as to loss on Well No. 16 and insolvency, was denied. The matter of receivership expense was waived at the original hearing, and was not discussed in petitioner's briefs nor at the hearing under Rule 50. *The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputations submitted.*"
> (Emphasis supplied.)

The court's statement that the matter of receivership expense was waived at the original hearing is based upon the following discussion between the court and counsel at the hearing on October 4, 1941 [R. 108]:

> "The Member: Do you have a statement for the respondent?
>
> Mr. Tonjes: There are other issues set forth in the petition, your Honor, and I presume that those are waived.
>
> Mr. Burkhead: That is correct.
>
> Statement of Case on Behalf of Respondent.
>
> Mr. Tonjes: That leaves five issues as stated by the counsel for petitioner.
>
> I might say briefly what my position is with respect to these several issues.
>
> The Member: First, before you start, you speak about others being waived. I was wondering about that, because there are a large number enumerated here. Are they waived or have some of them been disposed of by your stipulation?
>
> Mr. Burkhead: No. They have been waived. They are small items."

Obviously, counsel for petitioner had completely forgotten the issue as to receivership expenses; but by his statement that the issues waived "are small items" he clearly showed that what he had reference to were the issues raised in subsections (f), (n), (o) and (p) of paragraph 4 of the petition [R. 7, 8], aggregating $1,991.17 in amount. A waiver is, by definition, the intentional relinquishment of a known right; and certainly counsel for petitioner did not intentionally relinquish its right to a deduction of almost $12,000.00.

In any event, the question of prior waiver is removed from the case by the fact that the Tax Court, on the motion for rehearing, affirmatively undertook to decide the question as to receivership expenses, and was therefore required to decide the question correctly. In the excerpt from the order of February 29, 1944, above quoted, the court says that

> "The above issues were nevertheless reconsidered because the figures involved were incorporated in the recomputation submitted."

Petitioner's computations are in the record, and it can be seen therefrom that no figures were incorporated with respect to the issue as to loss on well No. 16 or the issue as to insolvency. The only issue concerning which figures *were* incorporated in the computations submitted was the issue as to receivership expenses.

On the merits, it is submitted that the liability for receivership expenses paid in 1936 did not accrue in prior years. A receiver, of course, is an officer of the court, subject to its direction and control. In California the powers of receivers are specified in Section 568 of the Code of Civil Procedure, as follows:

> "The receiver has, *under the control of the court,* power to bring and defend actions in his own name, as receiver; to take and keep possession of the property, to receive rents, collect debts, to compound for and compromise the same, to make transfers, and generally to do *such acts respecting the property as the court may authorize.*" (Emphasis supplied.)

Thus, a receiver cannot subject the assets of a corporation to liability without the approval of the court under whose authority he acts. As stated in *Pacific Ry. Co. v. Wade,* 91 Cal. 449, 27 Pac. 768, 770:

> "No one claiming a right paramount to that of the receiver can assert it in any action without the permission of the court. No sale can take place, no debt can be paid, no contract can be made, which does not receive the sanction of the court."

Until the court which appointed Armour as receiver approved his final account on November 12, 1936, and directed payment of the sums therein specified, there was no certainty that petitioner would ever be required to pay any part of the $17,852.12 for which deduction is now claimed. For this reason, until the order was made, petitioner was not entitled to deduct these receivership expenses as accrued liabilities. The case falls within the familiar rule, restated on February 28, 1944, by the Supreme Court in *Security Flour Mills Co. v. Commissioner,* 320 U. S. ......, 88 L. Ed. (Adv. Op.) 471, as follows:

> "It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent."

It is therefore submitted that the Tax Court erred in sustaining the Commissioner in the contention that $11,908.53 of the $17,574.68 claimed as a deduction for 1936 represented liabilities accrued in prior years.

IV.

Petitioner Sufficiently Established the Loss Sustained in 1937 on Surrender of Well No. 16.

The history of well No. 16 is set forth in some detail in the findings of the Board of Tax Appeals [R. 187-9]. The well was a small producer, and it declined in production at the end of 1937 [R. 117]. During 1937, up to December 20th, when the well was quitclaimed to Smith, petitioner had sustained a net loss on this well, before making any deduction for depletion, of $3,258.78 [R. 152]. Finally the well ceased producing entirely; it had "sanded out" and couldn't be pumped [R. 129]. The operating agreement between petitioner and Smith's predecessor in interest limited the expense chargeable against Smith's intrest to one-half of $500 per month [R. 117], which was not sufficient to operate the well [R. 124], and there was no way of charging Smith with any part of the cost of making necessary repairs [R. 131-2]. Furthermore, it was impossible to know in advance how much repair work would be required [R. 133-4].

The board of directors of petitioner was composed of practical oil men [R. 131]. They held a meeting on December 17, 1937, at which, after full discussion, they adopted a resolution to release, surrender, and quitclaim to Smith petitioner's entire interest in the well [R. 100-1]. Harold C. Morton, one of the directors, testified that he knew at the time that Smith had spent a great deal of money in attempting to return to production two wells located on the same ten-acre tract [R. 118-19]. The directors discussed the possibility of dividing up with Smith as much of the physical equipment as could be salvaged, but under the terms of the lease the lessors had a right to possession of the equipment upon abandonment.

Under all the circumstances, the directors decided to turn everything over to Smith, including the equipment [R. 124-5]. The well went off production on December 17th and was quitclaimed on December 20th [R. 152].

Fortunately for Smith, the repair work necessary to put well No. 16 back on production proved simple and inexpensive. He found the liner crumpled, but not totally collapsed, and the entire cost was only $700 or $800. About a year and a half before, while the well was being operated by Smith as a trustee in the case of *Julian v. Schwartz,* the liner did collapse, and it cost between $18,000 and $20,000 to accomplish no more than Smith was able to do at the end of 1937 at a very small expense [R. 130-1].

By quitclaiming to Smith, petitioner relieved itself of an onerous liability. Under the terms of its 1928 agreement petitioner was required to operate the well, even at a loss, so long as it retained possession [R. 124, 126]. It undoubtedly chose the course of wisdom in surrendering the well to Smith, for although the well produced over $15,000 worth of oil in 1938 [R. 132-3], as compared with only about $10,000 in 1937 [R. 151], production then declined to about $700 or $800 a month [R. 133], and even if petitioner had been able to put the well back on production at a cost of as little as $500, it would have sustained a loss in operating the well because of the limitation on Smith's share of expenses [R. 139-140]. Furthermore, in quitclaiming the well to Smith, petitioner shifted to him the ultimate liability for conditioning the well for abandonment in compliance with state law. This might have cost between $5,000 and $10,000 [R. 134]. By quitclaiming to Smith, petitioner surrendered its interest in the well without incurring this liability.

Although Smith was a large stockholder of petitioner, the transaction was free from any suspicion of intent to benefit him at the expense of the corporation. The matter of surrendering possession of the well to him was not suggested by Smith but by Morton [R. 125]. Smith refrained from any participation in the discussions as to the advisability of the transfer [R. 127], and the resolution records him as not voting [R. 100]. Neither Morton nor any other of petitioner's shareholders had any interest in Smith's operation of the well [R. 127].

In his notice of deficiency the Commissioner disallowed the loss on abandonment of petitioner's interest in well No. 16 "as not falling within the provisions of Section 23 of the Revenue Act of 1936" [R. 50], and at the hearing counsel for the Commissioner placed his objection on the grounds that the quitclaim was to a stockholder, that no effort was made to salvage any property, and that if there was a deductible loss it was one to which capital limitations applied [R. 110]. These objections are obviously without merit. In the case of *United Oil Co.*, 25 B. T. A. 101, 109, the Board of Tax Appeals said:

> "Losses sustained on account of the abandonment of oil wells constitute allowable deductions from income for the year or years in which abandoned, and this principle has been specifically recognized by the respondent. Belridge Oil Co., 11 B. T. A. 127, 137."

The evidence shows that Mr. Smith's position as a shareholder did not influence the decision of the board of directors as to the advisability of surrendering the well to him. No effort was made to salvage the well equipment because Smith already owned a half interest in this equipment [R. 124] and because the lessors had the right to possession upon abandonment [R. 125]. And the surrender

to Smith was without consideration and hence not a "sale or exchange" to which the capital loss limitations of Section 117 could apply.

The Board of Tax Appeals' disallowance of the loss is based entirely upon an alleged failure to prove the amount thereof. The Board states that this was the basis of respondent's contest of the deduction [R. 211-12]. This statement rests upon a misconception of the meaning of certain remarks made by counsel at the time of the hearing. One of the principal issues in the case was whether sums expended by the trustees in operating the wells, which sums were charged to petitioner, should be taken into consideration in computing the depletion deduction. Accordingly, it was impossible, before this issue was determined, for petitioner to prove definitely the amount of loss sustained upon abandonment of well No. 16. Counsel for respondent, Mr. Tonjes, was anxious to keep out of the record any documentary evidence which might tend to establish depletion in accordance with petitioner's contentions. Thus, when petitioner attempted to offer in evidence a document entitled "Barnhart-Morrow Consolidated Gross Income, Expense, Depletion, Net Income," Mr. Tonjes objected to the offer for the reason that it attempted to show what was a proper depletion allowance, and the offer was therefore withdrawn [R. 149-50]. When the witness, George F. Meitner, petitioner's auditor, then attempted to identify the document ultimately received as Exhibit No. 57, entitled "Loss on Oil Wells Quitclaimed and/or Abandoned in Year 1937," Mr. Tonjes examined the witness on *voir dire* to satisfy himself that the item of $28,472.01 shown on the exhibit as "Depletion Reserve December 31, 1935," represented depletion prior to the time the trustees took possession [R. 153-5]. Mr. Tonjes then elicited the information that the items shown

on the exhibit as depletion on the trustee's distribution in 1936 and 1937 were calculated on the amount of gross proceeds of oil credited petitioner by the trustees, that is, in accordance with petitioner's contentions on the depletion issue [R. 155]. Counsel for petitioner recognized that respondent would therefore have a legitimate objection to the exhibit on the ground that it purported to show what was a proper depletion allowance, and in order to avoid this objection, counsel stated that he offered the exhibit

> "for the purpose of showing the method and the manner in which petitioner arrived at the figure $43,-151.96 which the petitioner has claimed to have sustained as a loss on Well No. 16 at the time it was abandoned in 1937, and not for the purpose of showing that it is evidence of the fact that they did sustain that, but to show how we arrived at that figure, to show our method of computing" [R. 155].

When the court then admitted the exhibit in evidence "for the purpose stated by counsel," it was understood by counsel that the exhibit was evidence for all purposes except to show proper depletion allowances on the trustees' distributions or to show the proper *total* amount of the loss sustained by petitioner, which total amount necessarily involved the question of depletion. Certainly the exhibit would have been entirely immaterial had its only effect been to evidence the mental process of petitioner's auditor. The issue was as to the amount of the loss. This clearly appears from the introductory question put to the witness, in which he was asked to state how the figure of $43,-151.96 claimed as a loss was established [R. 153]. At no time did counsel for respondent question the veracity of the statement as evidence of the original cost of the well.

This is the entire explanation of Mr. Tonjes' earlier statement [R. 119] that while he thought the total sum of $43,151.96 claimed as a loss "might be correct," he did not concede the amount. The total was not conceded because it embodied a disputed element of depletion, but for no other reason.

Petitioner's Exhibit 57 shows that the cost, less depreciation to December 20, 1937, of the tangible well equipment on well No. 16, was $14,914.75 [R. 157], that the intangible drilling costs, less depletion, came to $28,237.12, and that the adjusted basis of petitioner's interest in the well was the total of those sums, or $43,151.96 [R. 158]. The Tax Court's order of July 30, 1943 [R. 270-2] shows the income from well No. 16 for 1936 and 1937 as follows:

	1936	1937
Gross income	$46,981.24	$20,688.87
Net income	26,783.53	16,060.02

Depletion for these years, computed at 27½% of gross income or 50% of net income, whichever is lower, amounted to $10,344.43 in 1936 and $7,365.47 in 1937. The sum of these figures, $17,709.90, is $251.81 more than the total depletion for the same years shown in Exhibit 57 [R. 158], so the loss on surrender of the well is reduced from $43,151.96 to $42,900.15.

Mr. Meitner, petitioner's auditor, testified that the figures shown on Exhibit 57 were taken by him from petitioner's books [R. 153]. These figures, however, were rejected by the Board because "respondent never agreed that petitioner's books reflected actual cost of the well" [R. 212]. We respectfully submit that petitioner's books are *prima facie* evidence of the facts they purport to rep-

resent and that this rule of evidence is not conditioned upon the prior agreement of the Commissioner as to their accuracy. In the instant case there was no evidence or even assertions of counsel to challenge the accuracy of the book entries. Under such circumstances, to deny a corporation the evidence of its books of account would be to leave it at the mercy of the Commissioner as to all matters except those still within the memory of its officers and employees. The mere assertion of such a doctrine is shocking to one's sense of fairness. In *Commissioner v. Brier Hill Collieries* (C. C. A. 6), 50 Fed. (2d) 777, at 778, the court said:

> "The Board has frequently held that the balance sheets of predecessor and successor corporations are evidence of asset values. Fidelity Storage & Warehouse Co., 2 B. T. A. 371; Munising Motor Co., 1 B. T. A. 286; Northeastern Oil & Gas Co., 5 B. T. A. 332. Not only did the books of the Crawford Company show these values, but the same items at the same values were transferred to the books of the taxpayer upon the taking over of the properties. Nothing appears in the evidence from which it is to be inferred that the books of either company did not show, as they purported to do, the true value of the assets. In this situation we think the Board should have accepted the book values. Newton v. Consolidated Gas Co., 258 U. S. 165, 42 S. Ct. 264, 66 L. Ed. 538. Kings County Lighting Co. v. Nixon (D. C.), 268 F. 143."

In *B. F. Edwards*, 39 B. T. A. 735, at 737, this rule was accepted by the Board when it said:

> "The assets of a corporation may be considered in arriving at the value of its stock, *Lillian G. McEwan,*

26 B. T. A. 726, and in the absence of any different showing, the book value of those assets is some evidence of their actual value sufficient to shift the burden of going forward to the respondent. See *Wessel v. United States,* 49 Fed. (2d) 137; *Commissioner v. Brier Hill Collieries,* 50 Fed. (2d) 777."

And very recently, on May 31, 1944, in the case of *Waldo B. Russell,* C. C. H. Dec. 14,007(M), the Tax Court was even more explicit, saying:

"As to the deduction for patent depreciation which respondent has reduced for failure to show an adequate basis, we think the question close but have concluded that petitioners have borne their burden. It is stipulated that 'the books of Russell Box Company show that . . . the patents were transferred to . . . (petitioner) at an amortized value of $9914.56,' which is the amount used by petitioners as its basis. No contradictory evidence was introduced by respondent who admits 'that such books make such showing,' and merely contends that the books are no evidence whatever. While certainly not conclusive, we have held that entries appearing upon books regularly maintained in the operation of a business furnish some evidence of the facts shown, sufficient to place upon respondent the burden of going forward. B. F. Edwards, 39 B. T. A. 735. We think that rule should be followed here. The entry in question purported to state a fact, namely, the figure at which the property was transferred. It would be necessary to conclude that this fact was misstated in order to disregard the book entry completely. In the absence of some evidence on the subject justify-

> ing at least the creation of suspicion, we do not regard so drastic a procedure as required. On this issue petitioners are sustained."

The opinion of the Board member in this case questions whether the $17,889.48 shown as depreciation on tangible well equipment is the full amount allowable within the meaning of Section 113(b)(1)(B) of the Revenue Act of 1936 [R. 212-3]. This must be assumed, in the absence of any evidence to the contrary or objection by the Commissioner. To require the taxpayer, in every case of loss, to prove that the depreciation taken and allowed was as great as would be "allowable" by the Commissioner, in the absence of any issue raised by the Commissioner himself, would be to require a useless waste of the time of the courts and counsel. The very least that the taxpayer has the right to expect, if the question is raised by the court itself, is an opportunity to supply the deficiency in proof. Here petitioner's motion for a rehearing stated [R. 236]:

> "We also petition for a rehearing because, if there be any question that the proof as introduced failed to clarify any of these matters, Petitioner asks for a rehearing to the end that all of such matters can be made clear beyond possibility of doubt. The facts involved are not susceptible of dispute, and the interest of justice, we respectfully submit, requires that all of the facts be before the Board with the utmost clarity."

Yet this motion for rehearing was summarily denied [R. 244].

In this connection we call attention to the case of *Forrester Box Co. v. Commissioner* (C. C. A. 8), 123 Fed. (2d) 225, 228-9, where the court said:

> "The Board ruled that the lawful basis, for determining gain was $128,571.36 less whatever depreciation was allowable during the years 1922 to July 1, 1929. The Board held that the burden of showing the amount of allowable depreciation was upon the petitioner, and that, since it had failed to sustain the burden, the Board had no alternative but to approve the respondent's determination.
>
> *   *   *   *   *   *   *   *
>
> "It is apparent that the petitioner's evidence was directed toward proving the nonexistence of actual depreciation, and not toward proving the amount of allowable depreciation. The petitioner demonstrated that the respondent's determination was based on an erroneous theory, but it failed to prove, as the Board has pointed out, the amount of depreciation which was allowable from 1922 to 1929 with respect to the machinery and equipment. The Board was of the opinion that a far greater depreciation was allowable than the petitioner had taken. In effect, the Board ruled that, while the respondent's determination, which had been appealed from by the petitioner, was based on an utterly untenable theory, the petitioner must accept that determination because of its failure to show that its own theory as to the basis for determining gain on the sale of the machinery and equipment in 1929 was correct.
>
> "It is obvious now that both the respondent and the petitioner were shooting wide of the mark in the proceedings before the Board. It is also apparent

that if the Board's order is affirmed, the taxpayer will, in all probability, be required to pay taxes in an excessive and arbitrary amount. While it may be true, as the Board remarks, that allowable depreciation on $128,000 worth of machinery during 7½ years must have exceeded $1,893.89, it would seem to be equally apparent that the allowable depreciation on such machinery would not have been as great as $128,000. Under the circumstances, we think that it was the duty of the Board, after it had decided what the proper basis was for determining gain, to afford the petitioner an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929. See and compare, Helvering v. Taylor, 293 U. S. 507, 515, 516, 55 S. Ct. 287, 79 L. Ed. 623; Clements v. Commissioner, 8 Cir., 88 F. 2d 791, 793; Johnson v. Commissioner, 8 Cir., 88 F. 2d 952, 956; National Lumber & Tie Co. v. Commissioner, 8 Cir., 90 F. 2d 216, 219."

See also, in this connection, the following cases:

Royal Highlanders v. Commissioner (C. C. A. 8), 138 Fed. (2d) 240, 245;

Eau Claire Book & Stationery Co. v. Commr. (C. C. A. 7), 65 Fed. (2d) 125, 126;

Underwood v. Commr. (C. C. A. 4), 56 Fed. (2d) 67, 72-3.

The opinion further states that the record is devoid of any evidence to show that the intangible drilling costs of Well No. 16 were not "deducted as ordinary and necessary business expenses in the year in which they were incurred, as permitted by article 243, Regulations 74"

[R. 213]. One complete answer to this suggestion is that a corporation which agrees to drill a well in consideration of an interest in the well site is not permitted to deduct the drilling costs as an expense. In *Hardesty v. Commissioner* (C. C. A. 5), 127 Fed. (2d) 844-5, the court said:

> "Taxpayers seek a deduction from gross income, predicating their case solely upon the provisions of Article 23(m)-16 of Treasury Regulations 94. The drilling and development costs dealt with by this article are those incurred by a taxpayer in connection with the development of his own property or lease. * * * The regulation was not intended to and does not apply to costs incurred in the drilling of oil wells on the lands of others, or to costs incurred in connection with the drilling of wells as the purchase price of or as consideration for an interest in the lands of others."

The decision of this Honorable Court in *United States v. Sentinel Oil Co.,* 109 Fed. (2d) 854, cert. den., 310 U. S. 645, 84 L. Ed. 1412, is to the same effect. Petitioner's agreement of September 28, 1928 to drill Well No. 16 at its own expense was made concurrently with the transfer to petitioner of the lease of the well site [R. 187] and was obviously the consideration for that transfer. That this was a capital transaction was in effect conceded by the allowance to petitioner of depletion on the production of Well No. 16. See *Commissioner v. Rowan Drilling Co.* (C. C. A. 5), 130 Fed. (2d) 62, 63-4, where the court said:

> "The Rowan Drilling Company having given its drilling services in consideration of oil payments, the costs incurred by it as a consequence of the drill-

> ing constituted the purchase price paid by it to acquire a capital asset. This much seems to be conceded by the taxpayer, for it claimed depletion deductions with respect to its income from such oil payments."

Furthermore, Exhibit 51 shows intangible costs of Well No. 16 under the heading of "Capital Assets" [R. 103]. The suggestion that, while capitalizing these items on its books, petitioner might be "expensing" them for income tax purposes, was conjured up by the Board and is not based on any evidence or taken from any statement made to it by counsel for respondent. This suggestion is refuted by the fact that the intangible drilling cost of Well No. 16 increased from $60,908.31 as of December 31, 1935 [R. 103] to $74,167.31 as of December 20, 1937 [R. 158], an increase of $13,259 during the very tax years here in question. The Board member must have known, and it *affirmatively appears* from Exhibits 60 and 61 [R. 181-182], that no deduction was taken for any sum expended for drilling in those years. Certainly, under these circumstances, it was improper for the Board to disregard the flat assertion in the affidavit of Mr. Meitner, submitted in support of petitioner's motion for rehearing, that "petitioner has never expensed intangible drilling costs" [R. 242].

Finally, the Board states that "no allowance was made by petitioner in the computation for the salvage value of the well" [R. 213]. The testimony of Harold C. Morton clearly shows that the well equipment was surrendered with the well, and the directors considered it a good bargain [R. 124-5]. There was nothing left from which petitioner might salvage any part of its loss.

If there *was* any deficiency in proof of the amount of petitioner's loss on Well No. 16, it can very easily be remedied, and common justice would require that petitioner be given the opportunity to submit any additional evidence required. As things stand, it appears that petitioner actually sustained a large loss which the Revenue Laws permit it to deduct in determining its income tax lability, but that it is being denied the deduction and taxed excessively on purely technical grounds. We firmly believe that if the cause is remanded to the Tax Court, counsel for respondent, knowing that all necessary additional evidence is available and cannot be controverted, will stipulate to the deduction in the full amount of $42,900.15 claimed.

Conclusion.

For the reasons above set forth, it is respectfully submitted that the decision and order appealed from should be reversed and remanded for further appropriate proceedings.

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